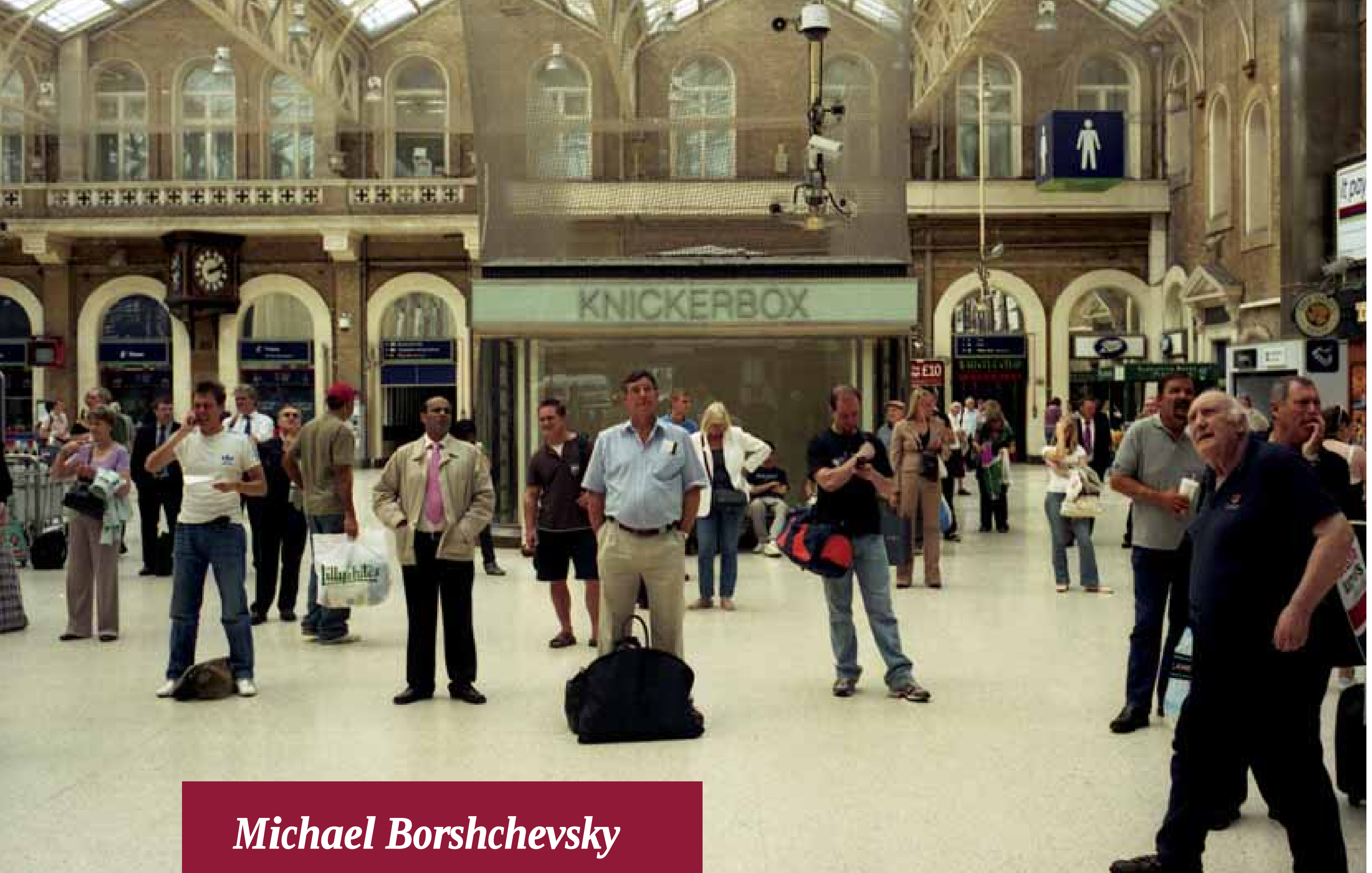

Michael Borshchevsky

A CRISIS OF EXCESS GROWTH

As we leave 2008 behind and endure 2009, there can be no doubt that the key event in the world is the ongoing global financial and economic crisis. It will be remembered not only by future historians but by all those who lived through it.
Newsreaders, economic journalists, politicians, diplomats, university professors and comedians have discussed and written about the current economic crisis. The financial community, on the other hand, with its traditional aversion to publicity has published very little written by its professional insiders. Exceptions to this rule are such authors as Ben Shalom Bernanke, Paul Krugman and George Soros, whose books and interviews provoke either intense interest or acute irritation.

PART 1

As we enter 2009 we have to address the following questions: how do we see the global crisis developing? Which courses of action are most likely to bring it to an end? What will be its global reach? How can we mitigate the effects of the crisis? And what hardships have to be faced as we strive to survive it?

Before looking for answers to these questions, I have to examine the underlying causes of the current crisis. Why did it develop so rapidly and what differentiates it from all the past economic downturns, which have been studied and described so extensively?

Everyone now accepts that we are, to our misfortune, witnessing and experiencing the worst economic downturn the world has ever known. The crisis has turned out to be not only global but also all-embracing — financial, economic, ecological, political, social, cultural and ideological.

Some of the recent stages which led up to the crisis are still fresh in everyone's memory. This crisis, which still has a long way to run, began to surface in the US with the collapse of the sub-prime property market. This was reflected in the US Stock Market resulting in a domino effect which caused tremors in stock markets around the world.

The heads of global financial institutions and governments in some countries have made considerable efforts to support their banks and leading industries. However, the trillions that have been pumped into the rescue plan have not stopped the downturn; they have merely put a brake on the slump in production and, hence, the fall in energy prices. The consequent rise in unemployment has led to civil unrest in a number of countries as fears of an uncertain future quickly take hold.

Despite the dramatic onset and spread of this crisis in the US property market, it would be naive to assume that any market crisis arrives without warning like a bolt from the blue. It has to be said that many experts were predicting it. A case in point is our own magazine which, in 2007, published an article by Herman Guelovani "And the Wolf Eventually Comes"[1]. Its author examined the economic causes that led to an era of continuous, excessive lending and explained why it would inevitably have to come to an end. Unfortunately, it is part of the human condition that very few people concern themselves with the prevention of foreseeable threats and challenges.

The current economic crisis started in financial markets, shifted into the economics of production and consumption, brought protestors onto the streets and turned before our very eyes into a crisis of the social institutions It has numerous causes. Some are conventional enough, for example, a disparity between financial assets and liabilities. Some other reasons are unexpected. Look, for example, at the European Economic Directive that allows the free movement of labour within the European Union. Recent civil unrest in Britain was caused by employing Italian and Portuguese workers exclusively on a contract instead of British workers. This demonstrated clearly that during periods of prosperity and economic growth Europeans of different nationalities are happy to embrace the European ideal. At the first sign of crisis and economic downturn, however, it is each man for himself and we see the appearance of political slogans "British jobs for British workers" and "Germany's jobs for Germans". This is extremely important for an understanding of the current crisis for which there is no precedent. I shall explain what I mean.

THE VIRTUAL FINANCE PHENOMENON

During the latter part of the 1970s, electronic technology swiftly took hold in the world of finance in the form of computerised payment systems and innovative financial instruments of lending and risk mitigation (for example, electronic credit cards and financial instruments, whose values are derived from values of something else, commonly known in financial circles as "derivatives").

[1] Herald of Europe issue 4 2007

In the beginning, the launch of these technologies was perceived as a process, which allowed for improvements in financial operations, a closer interaction between financial institutions and the consumers of their services, and an evolution in risk management. However, relatively quickly, in the mid 1990s, innovative technologies led to the widespread creation of a trend, which can be called "the virtual finance phenomenon".

"Virtual finances" are financial instruments, which are not guaranteed by any collateral, not by hard currency nor any other security such as gold, metals, other natural resources or property. For instance, technological development brought into being innovative electronic services in the transfer, cataloguing, usage and sale of information. Given the lack of precedent, these services were somewhat arbitrarily valued (and overvalued as a result) thus creating a boom in the so-called "dot com" companies in the late 1990s and early 2000s. Such companies distorted market perception and the nature of company valuation. Most significantly, these electronic "virtual financial resources" initiated a fundamental change in the role of money in the modern world.

In the last 30 years, all previous forms of dealing between financial institutions such as banks, funds, trusts, investment companies have been supplemented by a new variety of interbank relations. Instant online electronic forms of accounting for global interbank transactions (trade, lending, insurance or any other) have created an entire interbank network of electronic payment systems. This has led to the manifestation of "virtual finance", namely transactions which are purely electronic with no genuine collateral.

Electronic money was accounted electronically. This gave birth to various types of financial speculation; some of which were long-established and simply moved from paper into electronic form. Others surfaced in entirely new forms correlated to manifold usages of novel financial instruments of trade and direct finance (mostly long-term) with subsequent multiple discounted resale.

For centuries money has been used to equate to the expenditure of labour and resources and to determine the cost of goods and services. Now it has become not even a tradable good but a product of economy in its own right, traded between financial institutions as guarantees, loans, and other securitized assets. Such changes in pricing mechanisms and in the function of money as an independent medium of exchange caused the total financial assets of all world banks to be many times greater than the total volume of the global economy. Subsequently, many securitized assets that had been bought and sold by banks turned into so called "toxic assets", which are problematic to value and distort competitive lending rates (George Soros, Financial Times, 23/01/2009).

Even in 1661 Sir George Downing observed that "money, which was a medium of goods exchange, became a tradable good in itself". "Ducats, pounds, cekhinas and kronas became goods in their own right"

New speculative financial instruments, facilitated by electronic technology, combined the well-known mechanisms of a pyramid scheme with modern computerised know-how and allowed these "electronic pyramids" to spread swiftly like viruses. For example, there is a huge market in so-called Collateralised Synthetic Debt. The underlying collateral for such instruments includes other derivative contracts. Unfortunately, many market transactions based on similar schemes have cropped up over the last 15 years.

These pyramids range from multi-level marketing to the hedge fund-type of pyramid created all over the world by the notorious American financier Martin Armstrong. He opened these structures over and over again, using the money earned on the latest scheme to pay off the previous one. This allowed the pyramid scheme to continue over a long period. Another example of this is the Ponzi pyramid scheme operated by Bernard Madoff, former Nasdaq director, which resulted in an international scandal and serious financial losses for its numerous investors.

According to some leading analysts, the volume of operations based on derivatives amounts to a mind boggling sum of USD 1,000 trillion globally, which is many times greater than the total volume of the world economy.

The financial institutions lacked, simultaneously, both transparency and comparability of a number of financial operations, in particular, those based on derivatives. This lack of transparency was compounded by many banks typically treating these as off-balance items.

I was campaigning for transparency and standardisation of banking operations in Russian banks when I served as a representative of the Association of Russian Banks in London (1993–1998). Only later did I discover that the standards of Western banking are highly contradictory and often misunderstood even by those experts who have responsibility for banking supervision.

For example, the abolition of the uptick rule by the supervising authorities[2], (the uptick rule delayed bear-raids by allowing short-selling, or betting that the price of the security will go down, only when the prices were going up) literally paved the way to the bankruptcy of Lehman Brothers, the oldest bank on Wall Street.

Lehman was the largest player in the commercial short-term obligations market. These obligations were guaranteed by credit default swaps, promising the holder of the obligation compensation at par value (or face value of the security). Once the price of Lehman's obligations started to fall, panic spread through the market. Market players started to short-sell the obligations, thereby driving their price down further and increasing the prices of the credit default swaps. This example is one of many. It proves that the market supervising authorities, being highly bureaucratic in nature, are unable to fully understand and foresee the behaviour of the fast changing markets, which they are required to regulate.

A final point, quoting from the article by Herman Guelovani mentioned at the beginning of this section "The problem is no-one really knows how much liquidity has been created by any individual country, let alone globally. Paradoxically there is no place for real money…as a result of which a number of countries stopped publishing money supply indicators(completely abandoning such controls)…"[3]

[2] The **uptick rule** is a securities trading rule used to regulate short selling in financial markets. The rule mandates, subject to certain exceptions, that, when sold, a listed security must either be sold short at a price above the price at which the immediately preceding sale was effected or at the last sale price if it is higher than the last different price. In 1938, the SEC adopted the uptick rule, more formally known as *rule 10a-1*, after conducting an inquiry into the effects of concentrated short selling during the market break of 1937. The original rule was implemented by Joseph P. Kennedy, Sr., the first SEC commissioner. The SEC eliminated the uptick rule on July 6, 2007, concluding that the uptick rule "modestly reduce[d] liquidity and do[es] not appear necessary to prevent manipulation."

[3] Herald of Europe issue 4 2007

THE SHIFT OF INDUSTRIAL PRODUCTION WITHIN THE GLOBAL ECONOMY

Now we shall discuss another set of reasons, which gave birth to the current economic crisis. During the last 30-40 years there has been a rapid shift of the mass production of industrial goods to the markets where labour is cheap. Virtually all industrial production moved out of the developed European countries into South- East Asia and South America during the last 40 years. Cheap labour and new technologies allowed for mass production of goods on a huge scale, as well as for an immense reassignment of global natural resources to these regions.

Such global labour differentiation permitted so called Euro-Atlantic countries (Europe and the US) to specialise in the production of ideas and new technologies (know how), and in the reproduction of everything relating to this — science, education, culture. The realisation of these ideas happened mainly in South-Eastern Asia and South America. Moreover, Korea, China and India, and then Brazil became leading suppliers of so called "mass produced consumer goods" — all those things necessary for daily human existence — on a vast, previously unheard of, global scale.

This cataclysmic change, which occurred over a 25 year period, was not adequately thought through by the financial community. The large scale production and price-cutting in the trade of goods was further fuelled by freely available consumer credit. When lowered demand threatened a slow-down the expansion of production, it was elevated again and again by the wide availability and low cost of borrowing.

Gradually, it created a kind of "bubble" or "overhang", which was used as collateral for all types of commercial, investment and mortgage lending.

Thus, the Euro-Atlantic zone and its population became "addicted" to credit. Credit became a motor of global development both of industrial production and end user consumption. This coincided with the universal use of credit cards and electronic payments, and a further stimulus to consumer demand. Credit was utilized to buy a house, a car, a holiday or private education.

Thus of the two phenomena described above, two halves of the apple united: on one side, the virtual finance phenomenon, on the other side, the overwhelming demand for it, which prevented the bubble from bursting for a long time. Then the following came about: what we can call inadequate valuation (over-valuing) spread from the information domain into production, principally, into the energy sector. Oil was used as collateral for short-term speculative financial instruments (such as oil futures). Hence prices became distorted well beyond any relationship to the material and labour resources expended.

The recent sharp fall in the price of oil, from USD 150 to USD 40 per barrel (-73%), has far exceeded the contraction of global industrial production which proves that the price during the time of economic boom was too high.

The surplus of money had to find a bearing; and it found it — in oil. Oil futures became another outpost of virtual finance.

The overvaluation of oil, gas and electricity spilled over and into production costs. This puffed up bubble of pseudo-money, like an airship filled with gas, started to puncture. The largest hole was the recent mortgage crisis in the US. Ten years before that saw the growth of the so called “Asian mushroom”. That was a crisis of the overheated economy, a crisis of unsustainable asset prices in Thailand, Malaysia and other countries in South-East Asia. Many weaker economies suffered as a result of the financial contagion. Falling commodity prices, for example, triggered the Russian financial default in 1998. However, it was not the primary reason for the collapse of the rouble. A type of “virtual finance” existed in Russia at that time in the form of government treasury obligations (widely known as GKO). The collapse of the GKO pyramid and the subsequent inability of the Russian government to meet its obligations had major implication for the international investment community as a whole.

The current crisis started in the information sphere, extended into energy, and thereafter, into all types of human consumerism. This meant, that all kinds of products and services were affected and consumers (companies and individuals), all of us, had to take on more and more credit. This caused acute overproduction — wide availability and large stocks of goods in contrast with the shortages of money as credit became scarce. The global economic crisis is widely debated under several headings, as a mortgage crisis, a systemic failure of banking and financial institutions or as a crisis of the IMF and global monetary policy.

The role and participation of governments in all this is crucial. Governments were tackling balance of payments issues, as well as military and social programmes, while at the same time immensely increasing their internal and external debt. The recent wars in Afghanistan and Iraq, for instance, absorbed trillions of dollars.

All this virtual economy was included in the statistics and the calculation of GDP. This distorted the true economic picture, making it appear prosperous and showing steady growth in the global economy. Sooner or later this should cause concern, because, according to development theory, one should be wary of undeviating growth. Growth cannot be exponential.

Modern economic growth is not everlasting, as historians have shown; it started near the turn of the 18th to the 19th century. It is only 200 years old. From the perspective of world history it can seem like an anomaly. Before that the development of civilization was a lot less dynamic[4].

There are always limits to growth (as was proved by Donella Meadows, J Forrester and others in their economic model presented at the Club of Rome in 1972)[5]. Finance has long since lost contact with demography, the economy and reality. Exponential economic growth of 11-12% in China, of 6-7% in Russia, and of 2-3% globally should have caused anxiety not applause. Instead, the whole chimera was held up by the hedonistic philosophy of infinite consumption. Now the global picture must change painfully, but inevitably. The “bubble” had to burst and it was ripped open. There is a long and hard sobering up ahead of us; finance has to be brought back into line with the real economy.

However, the “virtual finance” phenomenon became so great and powerful that it is practically impossible to imagine that it will be forbidden or disappear. The question is, from my point of view, how to find a realistic measurement for distinguishing between real and virtual finance. One limitation is obvious, that the volume of “virtual finance” should not be larger than the volume of the total economy. In addition, it should be used as collateral for long-term financial undertakings, with gradual replacement of the virtual collateral into real (a type of hybrid financial instrument).

The concept of sustainable development first came under discussion at the Earth Summit in Rio in 1992, and was adopted by the UN in its environmental programme for mankind. This is fundamentally incompatible with the idea of exponential growth.

SYNCHRONIZED REPRODUCTION[6]

I remember a conversation I had with Wassily Leontief the illustrious American economist of Russian descent. This Nobel Prize Laureate was the exponent of the famous general equilibrium theory in inter sector relations and the progenitor of Input-Output matrix analysis. Our conversation took place during a visit he made to the USSR in the mid 1970s. One idea that Leontief voiced publicly was that of importing central planning methods into the US economy. My question to him was: “are the methods of central planning compatible with the free market and, if so, in what way”. My interlocutor replied that he was not, of course, intent on “killing the goose that lays the golden eggs” i.e., the free market. “What I am saying is more about correlative

[4] *Collapse of an Empire: Lessons for Modern Russia* by Yegor Gaidar, Antonia W. Bouis (Translator) Publisher: Hopkins Fulfillment Services, Publishing Date: October 2007, (ISBN-13: 9780815731146)

[5] Donella H. Meadows, Dennis L. Meadows, Jørgen Randers, and William W. Behrens III. New York: Universe Books (ISBN 0-87663-165-0). Jay W. Forrester 1971. *World Dynamics*. Wright-Allen Press.

[6] In Marxian economics, economic reproduction refers to recurrent (or cyclical) processes by which the initial conditions necessary for economic activity to occur are constantly re-created. ..... As an approach to studying economic activity, economic reproduction contrasts with equilibrium economics, because economic reproduction is concerned not with statics but with dynamics, i.e. the motion of an economy. It is not concerned with the conditions of a perfect match of supply and demand under idealized conditions, but with quantitative proportions between different economic activities or sectors which are necessary in any real economy so that economic activity can continue and grow. And it is concerned with *all* the conditions for that, including social and technical conditions, necessary for the economic process. Wassily Leontief developed Marx's idea further in his input-output economics.

market prognosis of the reality of production, based on the assessment of demand", said Leontief. "But how do you suggest treating price determination?" was my next question. "Forecast it using real income", he said. It was clear to me, living and working as I then did in a socialist economy, that the subsequent steps would unavoidably lead to socialism in its absolute form.

This memory of my clever and fascinating companion has a relevance to this article. Naturally, today the world is desperately seeking a way out of the crisis, in ways which I have touched on here. In the current climate, the first priority is to analyse today's economy. What products does it produce and in what quantities? What are its average production costs and profit margins? How are production and consumption distributed between various countries and regions? Finally, how does the financial system serve industrial production? Alternatively, it may work against it. Whose interests as nations or social groups does the financial system serve? Leontief's inter-industrial equilibrium and input-output tables come into my mind unbidden. This, however, is only a descriptive part, albeit, an important one. We have to proceed to an understanding that the world lives in accordance with the laws of reproduction: biological, demographic, social-sector, cultural, economic, financial and ideological (in terms of reproduction of ideas).

All these types of human activity are interrelated. They have inherent characteristics, cycles, and resources, regional, historical and cultural differentiations. A crisis only occurs when a balance between some of the factors of reproduction is distorted in such a way as to threaten human existence. Specifically, such a crisis occurs when the economy comes into sharp contradiction with the needs of society or with the volume and quality of consumed resources.

The current crisis moved from the virtual financial sphere into the sphere of real finance, and subsequently into the real economy. Many production facilities were closed, construction either slowed down or projects were cancelled. Consumption has started to fall. Loss of output comes at a price. But the finance that the government has injected into the economy to date, has not yet been able to stop the slowing down of the economy.

The government may buy shares in automobile and steel production plants in an attempt to support the producers and ensure that the blast furnaces keep on working. But in doing this, the government only aggravates over-production. In order for the markets to continue working, the money, which is injected into the economy, must reach both producers and consumers.

Modern technology-based civilisation is simultaneously extremely complicated and extremely fragile. The life of the biosphere can only survive within very narrow parameters of temperature, pressure and atmospheric conditions. Similarly, the technology sector relies on a very narrow range of fluctuation in energy systems and pressure in pipe lines. The global financial system of currencies, interest rates, credit guarantees, a proliferation of financial instruments and regulatory bodies, also has limitations, which it can be dangerous to exceed. Ignoring these limitations can cause imbalances, whether in the technology sector, the infrastructure or the economy. This can have dire effects in the social sphere, with the risk of hunger, epidemics and wars. For instance, the financial crisis of 1907, led to the First World War. That catastrophe failed to bring the world into balance and, as a consequence, led on to the Second World War. After the devastation and blood-letting in Europe and Russia, the slow process of growth began to revive.

If today the world does not understand the nature and reasons for the current economic crisis and does not find a way out of it, the outcome could be even uglier. It is clear that the current crisis is already causing sharp imbalances in the economy. Distortion of the financial sector reproduction has a huge impact on reproduction elsewhere in the economy and could put at risk the elements of reproduction at the human level — demographic, cultural, and professional. Ultimately these could lead to political instability, possibly on a world scale. It is therefore important for us to try to understand where to direct our efforts to solve the problem with our huge but limited resources. It is necessary to come back to the models of reproduction, most vitally, demographic and economic (according to the main areas of consumption). This would involve defining the conditions, necessary to sustain modern civilization by utilizing the economic, financial and human resources that already exist.

Recently, there have been many prescriptions of how to end the crisis. Amongst others, there are proposals to write off existing internal and external debt, to limit the volume of interbank transactions and to tighten banking supervision, to introduce a new international currency (this suggestion was made by the president of Kazakhstan, but it is unclear how such currency would be guaranteed). So far, the global community has not reached a consensus on what prescription would be the best.

■ ■ ■

The measures so far taken by many countries to support the financial sector and limit the impact of the economic downturn have been to funnel government money to banks and industrial producers. In other words governments are nationalising their economies, with all its consequences. In the global economic era of the last quarter of the 20th century, we saw a union between free-market countries ("open societies" according to Karl Popper) and fully planned or mixed economies of totalitarian regimes. This was helped by the transfer of industrial production from the Euro-Atlantic to the Asian and South-Asian parts of the globe. Through this union, South-Asian financial investment has become embedded in Euro-Atlantic economies. Modern China, for example, is the largest global dollar creditor, as well as the chief producer of the goods for mass consumption. It is still a country with a totalitarian regime and communist ideology, where human rights are far from the standards of an "open society". The question, which is already on the agenda, though it has not yet been fully understood or voiced, is — what political regimes will prevail in global politics once the current economic crisis comes to an end. If, indeed, it ends at all. ■

In Part 2 the author intends to look at the mechanisms limiting "virtual finances", to discuss necessary changes to the banking legislation and to suggest political and economic models of interaction between different economies.